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Economic Report

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The Window Is Open

Now that the elections are over, the Administration and the Congress must address two critical questions dealing with the economy. The first is, will the budget deficit shrink of its own accord? The second, if not, should we worry about it? I will tell you the answer right up front—and it's not just my opinion alone, but rather, the opinion of the overwhelming majority of people in the economic, financial, and business communities. No—the deficit will not go away unless something is done, and if it doesn't go away there may well be big problems down the pike.

The first thing to keep in mind, of course, is that the deficits referred to here are projections. As was noted in the September Economic Report, both the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) agree that the Federal Government's budget will remain in the red through the year 1989—and by a substantial amount. CBO's deficit projection for 1989 is $263 billion, while OMB's is some $124 billion less—but a huge deficit, nevertheless. Both agencies have used what they consider to be reasonable assumptions regarding economic growth and the revenues it throws off, Federal spending, inflation, interest rates, and changes in current laws governing taxes and spending.

Growth Assumptions Are Optimistic

Let's examine the growth assumptions because these are clearly critical. Neither OMB or CBO expects a recession during the 1985-89 period. Coming on top of the two years of economic recovery just completed, this would mean a seven-year expansion. Only once in the past 130 years did the economy grow uninterruptedly for such a long period of time. That was, of course, the 106-month expansion that started in February 1961 and lasted until December 1969. The only other expansion that comes even close to it was the 80-month expansion which began in June 1938 and lasted until February 1945.

Both expansions, I might add, are considered by the National Bureau of Economic Research to have been wartime expansions. And periods of war, the record shows, tend to lengthen expansions by an average of one year. Since the current period is peacetime in nature, it would be quite an accomplishment if the ongoing expansion lasted seven years: The longest peacetime expansion in history lasted only 58 months, while the average postwar peacetime expansion has lasted only 34 months.

Thus, if anything, both these projections might be too optimistic in terms of the contribution that economic growth can make to Washington's coffers. Besides this, there is the rate of growth itself. The Administration projects that the real gross national product will expand by an average annual rate of four percent per year over the next five years following a two-year average growth rate of about 5½ percent so far in this expansion. Again, there have been periods of time when the economy has grown this fast or faster—but they were wartime. In 1949-53 the economy grew at an average annual rate of five percent; in 1962-66 the rate of growth was 5.4 percent. Growth rates during peacetime have averaged only 2¾ percent in the postwar era.

Notwithstanding this, some economists think that a new age has dawned and that we can grow—not only at an average annual rate of four percent per year for the next five years, but by as much as 5.5 percent! The reason I mention this latter figure is that if we were to grow at this rate, the deficit would almost be eliminated by 1989, using the Administration's assumptions as outlined in the September Economic Report.

Those who think these high-growth estimates are realistic point to what they believe are changes in productivity and its impact on the potential of the economy to grow. They claim that the stagnant economy of 1979-82, and, more recently, the low-inflation, strong-dollar environment of 1983-84 have made both management and labor aware of the need to increase efficiencies to save companies and jobs. The technological revolution of the past few years which has led to widespread use of computers, word processors, robotics and the like has further boosted productivity, they claim. The faster productivity

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grows, the faster the potential of the economy to grow and the faster the economy *can* grow before capacity constraints enter the picture causing either slower growth, a pickup in inflation, or both.

Once again it is necessary to look at the record. In the postwar era, private business sector productivity has grown at an average annual rate of less than 2½ percent. In the early 1950s, private business sector productivity grew at an average annual rate of more than 3½ percent, but this slowed to the point where in the 1970s the growth rate averaged about 1½ percent. So far in the 1980s productivity has been growing at less than even this low rate—recoveries, the strong dollar, and technological revolutions notwithstanding. Thus, while it might be possible to rev up the economy to grow at a rate of 5½ percent (or even more, for that matter) over the next few years, it would seem that, in the absence of a significant improvement in productivity, this kind of growth rate would eventually lead to rapid inflation and another boom-bust cycle.

Interest Continues To Pile Up

Another thing to keep in mind is that as long as the Government keeps running budget deficits, the cost of servicing the Federal debt will continue to rise. As I observed in September, interest outlays, which last year totaled $90 billion (11 percent of Federal spending and 46 percent of the budget deficit), are projected by both agencies to rise substantially over the next five years. By 1989, interest outlays could total anywhere from 80 to well over 100 percent of the budget deficit—making it virtually impossible to *ever* eliminate the budgetary red ink. Indeed, as early as next year, net interest expense could very well equal all outlays for such discretionary programs as grants to state and local governments, including education and highways; foreign aid; the cost of Federal government operations; energy, research and development; services to individuals, including housing assistance, student financial aid and veterans' medical care.

There has been a lot of talk about what is controllable and what isn't controllable when it comes to government spending. In reality, there is only one uncontrollable government expense: interest. Given enough time and appropriate legislation, the government can cut any other expenditure—but it must meet its debt-service payments or face default.

If these arguments are credible and the deficit will not shrink of its own accord, then the question becomes: Should we worry about it? I say we should. The discussion above regarding interest costs alone should make one concerned about the consequences of continued deficits. The Administration forecasts rising interest outlays even though it projects interest rates falling on an annual average basis starting in 1985. It is difficult to understand how the White House can forecast lower rates when there would appear to be only three ways in which the deficit can be financed—each one of them suggesting high interest rates.

The government can borrow from abroad. This, of course, is possible only if U.S. interest rates in real terms are higher than those overseas. Indeed, this has been the case for more than four years and is the primary reason why the dollar has gone up by more than 70 percent during this time on a trade-weighted basis. Needless to say, besides the high interest rates involved, a strong dollar has adversely affected many industries that sell goods abroad or which compete with goods imported from abroad. Of course, by reducing the number of jobs available, this impacts our domestic economy, thus personal incomes and the ability of people to spend. You can see where this would adversely affect economic growth.

If Washington were to confine its borrowing mainly to the domestic financial markets, chances are interest rates would be even higher. High interest rates, of course, would affect those industries which are sensitive to the price and availability of money. These include but are not limited to housing, autos, big-ticket consumer durable goods—not to mention the cost of educating one's children, and so forth.

Finally, if the government were to borrow from the Federal Reserve, it would also lead to high interest rates—only this time through an acceleration of inflation. While inflation does tend to benefit debtors at the expense of creditors, in recent years interest rates have ridden far enough above inflation so as to alter this somewhat. Notwithstanding this, one wonders if more rapid inflation is what the supply-side economists have in mind, especially since they seem to keep talking about the "depressed" price of gold and other commodities.

To be sure, there are those who say that the deficit has helped the economy over the past couple of years and that the economy has been able to grow with slowing inflation even in the face of the huge amounts of red ink. All of this may be true—but it is past history. The deficits helped the economy—but only after they hurt it by absorbing increasing chunks of savings in 1981 and 1982 at a time when the Federal Reserve was holding money tight. Once the Fed loosened up, the stimulative effects of the deficits were allowed to work and the economy moved from recession to recovery. The 1981-82 recession, coming so soon after the recession of 1980, along with the strong dollar, which got that way because of high real interest rates, were the main reasons why the rate of inflation has come down as sharply as it has.

However, as I said before, all of this is past history. Now that the economy is growing, the government's financing needs are in competition with that of the private sector

and the extent to which it results in high interest rates is keeping interest-sensitive sectors from growing and is also affecting our foreign trade. Inflation may remain low as a consequence, but so will real growth. And let us not forget the fact that the annual cost of servicing these deficits, the interest cost, is rising steadily.

Suggestions For Cutting The Deficit

With this in mind, I would like to offer some suggestions as to how the deficit can be reduced given economic, financial and political realities. On the latter, it is clear that voters overwhelmingly rejected the tax increase proposed by Walter Mondale. President Reagan, as you know, has also weighed in against using tax increases to help close the budget gap. Cutting spending alone is not the answer, either, since only 15-20 percent of the budget is controllable at any one time given current laws, contractual obligations—and, of course, the level of interest payments.

Still there is no doubt that any effort to reduce the deficit has to begin with government spending since this is the true burden that Washington places on the economy. One way or another the private sector has to give up purchasing power in order for the public sector to spend. If Washington borrows from the financial markets, there is less money available for others and interest rates go up. If Washington raises taxes, people also will have less money to spend. And if Washington should borrow from the Federal Reserve, then the ensuing rise in the rate of inflation cuts everyone's purchasing power in the process.

Having said that, it seems to me that the only way out of this dilemma is for a combination of strategies. It is fairly evident that we cannot rely on spending cuts and tax increases alone to do the job. Let me outline what I think should be done.

Freeze Federal spending. By this, of course, I mean in real terms, letting nominal spending go up with the rate of inflation. It may not be easily achievable in the next few years since only a relatively small proportion of the budget is controllable due to existing laws, and so forth. However, as you can see from the example in the table, it does pay spectacular dividends in the form of less growth in government spending, and it might be acceptable to the greatest number of people, since they would know that every recipient of government outlays would be affected similarly.

Reduce interest rates. Interest rates in the CBO projections are still high relative to inflation. Some of this might be eliminated as progress is made on the budget deficit. But some could also be accomplished by a further easing on the part of the Federal Reserve. Surely, the Fed has room to ease further in the current context: The producer price index has fallen for three consecutive months for the first time since 1967; the money supply is currently at the bottom of the Fed's annual target range (unnecessarily constraining Fed policy for 1985, since the average of the current quarter forms the base for next year's target bands); there is still the problem of country debt and confidence in the U.S. banking system; and there should be some degree of ease to offset the fiscal restraint that would come from any efforts at closing the deficit gap. As you can see from the table, just a two-point drop in interest rates compared with CBO's assumptions would by 1989 lower government spending by $54 billion annually.

PATHS TO A BALANCED BUDGET

		Projections				
	1984(a)	1985	1986	1987	1988	1989
CBO Baseline Receipts	667	751	811	881	965	1042
CBO Baseline Outlays	842	929	1006	1097	1203	1305
CBO Baseline Deficit	−175	−178	−195	−216	−238	−263
Outlays less:						
Freeze real spending with 4% inflation		−53	−95	−150	−218	−281
2-Points lower interest rates		−10	−20	−30	−44	−54
1-Point more growth		−1	−4	−9	−17	−28
Adjusted outlays		865	887	908	924	942
Receipts plus:						
Cancel indexing		+5	+16	+30	+45	+63
2-Points lower interest rates		−2	−2	−2	−2	+2
1-Point more growth		+8	+22	+38	+56	+77
$5 tax per barrel of oil		+10	+10	+10	+10	+10
VAT @ 5%		+50	+50	+50	+50	+50
Adjusted receipts		822	907	1007	1124	1240
Difference: Adjusted receipts − adjusted outlays		−43	+20	+99	+200	+298

Sources: Congressional Budget Office; Treasury Department; MHT Co.

(a) actual

More economic growth. There is no way that the budget can be balanced if the economy is allowed to slip into recession. And while CBO does not project a recession over the next five years, it does project a relatively modest growth rate of 3.2 percent. Raising that by one percentage point—a possibility if other steps outlined here are taken—would cut outlays by $28 billion by 1989 and raise revenues by $77 billion at the same time.

Tax imported oil. With oil prices clearly under pressure, a tax on imported oil could accomplish several positive things at one time. For one thing, it would add to government revenues both from taxing imported oil as well as from the windfall profits tax that would occur as the price of domestic oil matches the level of imports. In the context of falling prices this would not add to inflation. Also, such a tax would keep oil prices high enough to continue encouraging our efforts to conserve.

Broaden the tax base. Several ideas are kicking around regarding broadening the tax base. Some profess to be

revenue neutral—but it would seem to me that Congress would be unlikely to do battle with lobbies, special-interest groups, and so forth just to wind up with no net gain in receipts. Besides, even if such a bill were to be fashioned, it would not mean that everyone's tax bill would remain the same, since those who lose their loopholes are unlikely to be made whole by lower tax rates because usage of loopholes varies, as you can imagine. It was very hard to get estimates of the revenue effect of broadening the tax base from the sponsors of the two major bills in Congress. Newspaper accounts have one of them adding only the relatively modest amounts of $20-$30 billion a year by 1989. What I did instead was inserted a value added tax (VAT) at five percent.

Cancel indexing. With inflation down significantly, it might not be a bad idea to cancel the provision scheduled to take effect in 1985 which adjusts the tax brackets to take into account the previous year's inflation. When the rate of inflation was in double-digits several years ago, such an indexing provision might have made sense, for it would have assured that people whose incomes went up only because of inflation would not wind up worse off as a result of moving into a higher tax bracket. These tax brackets, you will recall, are "progressive" in nature and were designed at a time of little or no inflation. But today's low rate of inflation means that movement in between these tax brackets has slowed considerably. Yet, as you can see from the table, there is a sizable revenue loss after a while.

If one were to reduce outlays and add to revenues by all the means suggested, one could come up with a budget that would be balanced during 1986 and would be nearly $300 billion in surplus by 1989. I don't think this is likely any more than I think that we will have the CBO baseline deficit of $263 billion at that time. However, if we could arrive at a combination of spending cuts and revenue enhancements that would split the difference, we would have a balanced budget by decade's end.

Balancing the budget is not impossible. It can be done if our elected officials have the will to do so. Right now the window is open. In the wake of his impressive victory on Election Day, the President's influence with Congress will never be greater. Yet at the same time, he is forever removed from the political process since he cannot succeed himself. Many members of Congress will not be returning to Capitol Hill in January. It would seem to me that now would be the most opportune time for starting concrete action to bring the budget deficit down.

The suggestions presented above are by no means intended to represent the only paths we can take to a balanced budget. But they do show that we can move in the right direction if we do more than just cut spending and raise taxes—both of which obviously raise political hackles. The path to a balanced budget may not be an easy one to take, but I would remind you of the answer that the great entertainer, Maurice Chevalier, used to give each time he had a birthday and he was asked how it felt to be getting older. His answer: It "... isn't so bad when you consider the alternative."

The same is true with the need to find the way to balance the budget. The path may be torturous—but considering the alternative it isn't so bad. ■

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